United States Department of Agriculture
FARM CREDIT ADMINISTRATION
Washington, D. C.

SUMMARY OF CASES

RELATING TO

FARMERS' COOPERATIVE ASSOCIATIONS

*
* *

Prepared under the direction of

L. S. Hulbert
Office of the Solicitor
Washington, D. C.

* *
*

COOPERATIVE RESEARCH AND SERVICE DIVISION

Summary No. 15 August 1942

Unauthorized Deductions by Milk Marketing Association

The case of Fietz v. Central Milk Producers Co-operative Association, 32 N.Y.S. 2d 574, was a consolidation of several actions brought against the association by members thereof for the purpose of recovering amounts which it was alleged had been unlawfully deducted from the sale proceeds of their milk. The court found that:

> There was a formal "membership application and contract" signed by the producer and corporation which in brief provided in conformity with the statute that the producer appointed the corporation as his agent to handle and market all milk sold from the farm or under the control of the producer, and the latter agreed to deliver such milk to the association in compliance with the regulations of the association and of the health authorities. There was further authorization to the corporation to handle the milk in such manner as in the opinion of the directors would promote the best interest of the producer with the sales to be made in the name of the corporation and the proceeds received by it.
>
> The corporation agreed, on its part, to use its best efforts as producer's agent to promote his best interest and agreed to pay the producer his pro rata share of net proceeds of milk sold after deducting all expenses, such payments to be made on an established date in each month. It was provided further that the corporation might receive milk from other producers who had not signed the contract who were termed "nonmembers." The producer agreed to comply with the bylaws; but if there are any bylaws they have not been produced in evidence. There was a further provision in respect to the cancellation of the contract by either party on thirty days notice. An important provision in both the certificate of incorporation, paragraph 8, and in the membership application and contract, paragraph 6, and which conforms to the statute, Section 69, Article 6 of the Co-operative Corporations Law, is the limitation of liability for each member or director as follows: "The amount of corporate indebtedness for which the members or directors shall be liable shall not exceed the sum of Five Dollars ($5.00)."

It appeared that the association

> made a contract with certain distributors in New York to furnish milk each day at an agreed price, and that each day a minimum amount should be delivered. Upon failure to deliver such minimum amount the distributors or their representatives were entitled to buy milk in the open

> market to make up this deficiency, and to charge the difference against the sums due to the corporation at the end of each month. * * *
>
> * * * * * * * * * * *
>
> During the year 1936 there was an unusual drouth in the locality in which these milk producers lived which greatly affected the quantity of milk they were able to produce and deliver to the Defendant.

Apparently, on account of the fact that the association was not able to deliver the required amount of milk to the distributors in New York it became liable to them for a substantial amount of money. As indicated, the claim in favor of the distributors arose in 1936.

> On August 9, 1938, the Defendant wrote to these producers as follows: "It has been decided that we will make no payment on account for July milk to producers who have withdrawn, but settlement in full will be made on August 25th." On August 25th the Defendant sent checks with the usual statement on which it was noticed that there had been a deduction of "proportionate share of deficiency (stating amount) to July 31st, 1938." This deficit practically consumed the amount of the August check for July milk. These actions are to recover the amount so deducted and unpaid at that time.

Apparently, the association attempted to justify the deductions made on the theory that they were an expense, but the court found that:

> The amount claimed by the Defendant was not an expense as that term is generally understood

and added:

> If the claim were to be accepted as valid, it represented damages for default of the corporation in the performance of its contract.

In rendering judgment in favor of the producers and against the association for the amount of the deductions involved, the court said in part:

> Each month, usually on the 10th, the corporation made payment to the individual producers by means of a check accompanied by a notice which in brief stated with figures the butter fat test, the number of pounds delivered, and the price per hundred weight, and the total sum of money representing the month's production. It does not appear that

the individual producers were given any notice of the expenses deducted by the corporation in such notice or statement. The Defendant had audits made of its books of account from time to time, but it seems certain that no notice was given to individual producers of any deficit or of any claim made by distributors in respect to failure to furnish the minimum amount on any particular day or in any particular month. Therefore, when the producer received his check and statement, he had reason to believe that the sum received by him was in full payment of the milk delivered the preceding month.

* * * * * * * * * * *

As already stated, the first intimation that the individual producers had that they were chargeable with any sum was when they received their checks on or about August 25, 1938.

It is difficult to determine any legal basis for such deduction from the checks from these individual producers.

* * * * * * * * * * *

Further, it would seem that this deficit was appropriated generally against the producers who were delivering their milk during the month of July, 1938. Some of these were not members or non-members delivering milk during the period that the deficit arose, and it is difficult to see how on any theory these men were chargeable with any portion of the debt.

Further, when the producers were paid by their checks each month under the circumstances heretofore stated, it was in the nature of account stated or accord and satisfaction between the two parties, and the producers were given no notice that anything remained unsettled or to be accounted for between them.

As indicated, the court found that the association was without authority, under the circumstances involved, to make the deductions in question. If, as the court apparently believed, the amounts in question did not represent expenses, then apparently there was no provision in the marketing contract which would have authorized the making of the deductions. Moreoever, the association was attempting to make deductions from the sale proceeds of milk of producers who were not members in 1936, when the claim of the milk distributors arose. It would, of course, be an unusual marketing contract indeed which would authorize the making of deductions in 1938, for meeting "expenses," which arose in 1936. Obviously in a normal case 1936

expenses should have been borne by the members of the association who patronized it in that year. Of course, if it is accepted that the obligations of the association to the distributors did not represent operating expenses for which deductions might be made by the association, then the association could not lawfully have made the deductions in 1936, under its marketing contracts. This case emphasizes the importance of having marketing contracts so drawn that they are adequate to meet the contingencies which an association may encounter and the fact that the management of an association should handle and account for products received strictly in accordance with its marketing agreement.

A principle which is sometimes overlooked is that an association may make only those deductions from sale proceeds which have been authorized by the members of the association. (Silveira v. Associated Milk Producers, 63 Cal. App. 572, 219 P. 461.) The fact that an association may need additional money or that it may desire to obtain funds for a desirable purpose, does not in and of itself operate to empower an association to make deductions from sale proceeds which the members have not authorized or consented to have made.

Again, the fact that it may appear desirable to the directors and officers of an association to pool products or sale proceeds derived therefrom and to distribute such returns on what is conceived to be an equitable basis does not empower the association to do so, where the marketing contracts of the association provide for the sale of the products of members individually and for individual accounting on the basis of the returns received from their specific products. (Steelman v. Oregon Dairymen's League, Inc., 97 Ore. 535, 192 P. 790; Cole v. Southern Michigan Fruit Ass'n, 260 Mich. 617, 245 N. W. 534.)

If the members of an association have received overadvances or overpayments from an association under its marketing contracts, then under normal conditions an association has a cause of action against the members for such amounts. (Arkansas Cotton Growers' Co-op. Ass'n. v. Brown, 179 Ark. 338, 16 S. W. 2d 177; Davidson v. Apple Growers' Association, 159 Ore. 473, 79 P. 2d 991.)

In many instances it is believed directors, officers and managers of associations do not realize that some or all of them in a proper case may be held personally responsible for losses suffered by members from unauthorized and hence illegal deductions. The rule applicable is stated in 7 R.C.L. Sec. 486, as follows:

> An officer of a corporation does not incur personal liability for its torts solely by reason of his official character. But if he commits a tort, he is liable for it; and it matters not what liability may attach to the

corporation for the tort, the officer must respond in damages if called on to do so. This principle is absolutely without exception, and is founded upon the soundest legal analogies, and the wisest public policy. To permit an agent of a corporation, in carrying on its business, to inflict wrong and injuries upon others, and then shield himself from liability behind his vicarious character, would often both sanction and encourage the perpetration of flagrant and wanton injuries by agents of insolvent and irresponsible corporations. An agent is responsible for torts committed in his principal's business only when they result from his own misfeasance or malfeasance and not when they consist of mere acts of nonfeasance; and this rule applies in the main to the officers and agents of corporations, though they can act only through their officers and agents, and for acts of nonfeasance merely they cannot be held liable to third persons. On the other hand the officers and agents of a corporation cannot escape liability for their acts of misfeasance or malfeasance on the ground that they were acting for the corporation.

See also Cone v. United Fruit Growers Association, 171 N. C. 530, 88 S. E. 860; Duncan v. Williamson, (Tenn.) 74 S. W. 2d 215.

Cooperatives - Treble Damages under Sherman Antitrust Act

The Farmers Co-Operative Oil Company "for itself and in behalf of all of its members who were members from March 6, 1935 to December 26, 1936" filed a complaint against twelve oil companies seeking to recover treble damages from them because of damages alleged to have been sustained from a violation of the Sherman Antitrust Act by the oil companies. (Farmers Co-Operative Oil Company v. Socony-Vacuum Oil Company, 43 F. Supp. 735). The action was brought against the defendants

> because of the alleged conspiracy of which the defendants are alleged to have been convicted on the 19th day of July, 1938, in the United States District Court for the Western District of Wisconsin, United States v. Standard Oil Co., 23 F. Supp. 937, in the case later in the Supreme Court of the United States, entitled United States v. Socony-Vacuum Oil Company et al., 310 U. S. 150, 60 S. Ct. 811, 84 L. Ed. 1129. The indictment in that case is exhibited on the complaint here and its contents are largely repeated in the several paragraphs of the complaint. Concisely stated, the substance of the complaint is that defendants combined and conspired together for the purpose of artificially raising and fixing the price of tank car gasoline in the spot markets in the East-Texas and Mid-Continent fields, and for artificially raising and fixing said tank car prices of gasoline and maintaining said prices at artificially high and noncompetitive levels, and that as a result of such conspiracy the price of gasoline in tank car quantities during the period named, to-wit, from March 6, 1935, to December 22, 1936, was maintained at an artificial level above that which the plaintiff's members would have enjoyed under unrestricted competition. The plaintiff alleges the purchase of approximately a million and a quarter gallons of gasoline at such illegally enhanced price, and that an excess of $2\frac{1}{4}¢$ per gallon was unlawfully exacted from it, and which plaintiff was obliged to pass on to its members by enhancing its retail price to members and others.

The defendant moved to dismiss the complaint upon a number of grounds, which the court said:

> might well have been molded into two or three instead of eight grounds. The grounds may, however, be fairly recited to include (a) "failure to state a claim upon which relief can be granted", (b) that plaintiff and its members are not similarly situated, and (c) the complaint fails to meet the requirements of Rule 23 prescribing the essentials of a class action.

In holding that the complaint should be dismissed, the court said in part:

> While the plaintiff quite constantly couples itself with its members when referring to the damage, it is to be noted that plaintiff specifically disclaims all individual rights in the business and association, and I think quite properly so. The statute under which the association is organized and operates specifies the use to which the earnings of the association must be devoted with great particularity. First, the operating expenses must all be paid. Second, a reserve up to equaling $1,000 or 50 per cent of the face value of the shares, whichever is greater, must be maintained. After the particular applications of earnings required by the statute are made, the net earnings must annually be divided among the shareholders in proportion to the amount of business respectively done by them with the association during the preceding year. From the very nature of the co-operative association, annually all losses are absorbed by the members and all net profits paid to the members. Now the complaint unreservedly sets forth that the excess price of 2¼¢ per gallon paid for gasoline was passed on by a like increase in the retail price to the purchasers. The complaint nowhere alleges the use of any particular amount of gasoline by the association, but if any portion of the purchases was used by the association, then it was a mere operating expense and is annually absorbed by the membership. It is quite clear, therefore, that so far as the plaintiff as an entity is concerned, it in no way sustained damage. If damage has been suffered, it has been passed on and absorbed by the members. So I think it is clear that whatever damage now remains uncompensated is due the respective members of the association, but such is not necessarily all that is due them. Let me illustrate: A is a member of the association and conceives that he has a cause of action against the defendants here, based upon a violation of § 1 of the Sherman Act, 15 U.S.C.A. § 1, and has determined to bring an action under § 15, 15 U.S.C.A., under discussion to obtain compensation. Now, A in stating his cause of action against the defendants would not at all be confined to his purchases from the plaintiff association, but would be entitled to aggregate all purchases made during the pertinent period, whether from the Association or others. It is not to be supposed that members of the association made no pur-

chases of gasoline except from the plaintiff, and any intimation of that kind that may be found in the complaint would plainly be conjectural for the manager of such association would have no means of knowing where each one of 700 members may have purchased gasoline. It, therefore, seems to me quite clear that plaintiff has failed to state a claim upon which relief can be granted to itself as an entity. It also seems quite clear that plaintiff and its members are not similarly situated, and that the complaint fails to meet the requirements of Rule 23 prescribing essentials of a class action, in that the relief prayed for as it applies to each of the 700 members is not a common relief, and a remedy can not be accorded by a single judgment. I think that plaintiff may not by merely calling this a class suit, thrust it into a court of equity to be tried as an equitable action, and thus deprive the members of their rights and the defendants of a right to have each individual case separately dealt with and tried to a jury. It therefore follows that the defendants' motion must and will be sustained, and the complaint dismissed for failure to state a claim upon which relief can be granted.

The statements in the opinion in the instant case to the effect that a cooperative association because of its nature would not "as an entity" suffer a loss which would entitle it to maintain a suit for treble damages appears to be dicta. In this connection attention is called to the following quotation from the opinion:

> From the very nature of the co-operative association, annually all losses are absorbed by the members and all net profits paid to the members. Now the complaint unreservedly sets forth that the excess price of $2\frac{1}{4}\phi$ per gallon paid for gasoline was passed on by a like increase in the retail price to the purchasers. The complaint nowhere alleges the use of any particular amount of gasoline by the association, but if any portion of the purchases was used by the association, then it was a mere operating expense and is annually absorbed by the membership.

It is true, of course, that the success of a cooperative redounds to the advantage of its members and that its losses redound to the detriment of the members, but this is precisely what occurs in the case of any business corporation. The "equities" of the stockholders of any business corporation, whether cooperative or otherwise, are directly affected by the success of the enterprise. It is true in the case of

a cooperative that economies and savings affected and "profits" made are distributed to the members on a patronage basis, rather than on a stock basis, but the method by which money is distributed should not be the key factor in determining if an entity has suffered a loss. The members or stockholders of any business corporation are, broadly speaking, its proprietors and the financial advantages which accrue to them from the operations of the corporation are directly affected by its success or failure. If the operating expenses of a commercial corporation are too high, just as in the case of a cooperative association, there may be nothing to distribute. Obviously until the time of distribution, savings "earnings or profits" of a cooperative are just as much the property of the cooperative as corresponding gains made by a commercial concern; and such savings, earnings or profits are held subject to the debts and liabilities of the cooperative, just as fully as in the case of a commercial corporation. (Associated Fruit Co. v. Idaho-Oregon Fruit Growers' Ass'n., 44 Idaho 200, 256 P. 99, 100.

The statements in the opinion to which particular attention has just been called do not appear to have been essential to disposing of the case, and it is believed that the real basis for the holding denying the association the right to recover is based on the fact that the cooperative, which apparently operated on a purchase and sale basis, had maintained its normal margin and had passed on to its customers the increase in the price of gasoline caused by the violation of the antitrust laws. This is in keeping with the holdings in several other cases involving private concerns.

In the case of Twin Ports Oil Company v. Pure Oil Company, 119 F. 2d 747, the court in passing upon a similar case said:

> It is evident from the argument of appellant's counsel in their brief that they found it impossible to show that an increase in the price of gasoline to appellant was not immediately reflected in a corresponding increase in the retailers' price during the years in question. Therefore, there was no loss in margins, nor in the sale of appellant's property that could be attributed to this so-called buying program. There was Cox's testimony, however, that, as a result of this buying program, the tank car prices of gasoline had been raised by a little over two cents per gallon. Of course this could in any event result in no damage to appellant, absent proof that its selling price was not correspondingly increased, and particularly since its contract with appellee protected the stability of its margins.

Likewise, in Leonard v. Socony-Vacuum Oil Company, 42 F. Supp. 369, the court said:

> It is clear to this Court that if the increase in price to plaintiff was passed on by him to his customers, he has suffered no pecuniary loss or injury to his business or property.

It appears to be clearly established in order for anyone to recover treble damages arising out of a violation of the Sherman Act that he must allege and prove that he has suffered damages to his business or property which he has not passed on to others.

In the case of Louisiana Farmers' Protective Union v. Great Atlantic & Pacific Tea Company, 40 F. Supp. 897, in which the association alleged that it had received oral assignments from each of its members, each of whom was engaged in the growing of strawberries in Louisiana, covering losses asserted to have been sustained by them, the court was of the opinion that the complaint did not allege with sufficient certainty that the action of the defendants had resulted in losses to the members of the association. In this connection the court said:

> It is true that we might speculate that the growers suffered to some extent from the repercussion, due to the effect upon the independent and other chain grocery stores of the sale of Louisiana berries as "loss leaders," but such damages, insofar as the allegations of the amended complaint show, would be speculative and remote, rather than direct. It does not necessarily follow, however, that even if the defendants had sold the strawberries at higher prices, the growers would have received a higher price for their crop. The plaintiff so concludes in its complaint, but there are no allegations of fact therein upon which to base such a conclusion. It is well known that ordinarily consumption increases as the price of a commodity declines, and that consumption decreases as the price is raised. The sale of strawberries as "loss leaders" by the defendants did not necessarily damage the growers, and there are no allegations of fact in the complaint showing that they were proximately injured thereby.

It is believed that there is no lack of capacity in a cooperative association, as such, to maintain a suit for treble damages under the Sherman Act, if it has actually suffered damages to its "business or property" from a violation of the antitrust laws. In any instance in which a private concern could maintain such a suit, no

reason is apparent why a cooperative association, under comparable conditions, could not also do so. It is to be kept in mind that the right to bring a suit for treble damages because of a violation of the antitrust laws is a right conferred by statute and unless the terms and conditions of the statute are met, such a suit may not be maintained by anyone. If a church has suffered a loss to its property because of a violation of the antitrust laws, it would appear that it could successfully maintain a suit for treble damages.

In the case of Chattanooga Foundry and Pipe Works v. City of Atlanta, 203 U. S. 390, 27 S. Ct. 65, 51 L. Ed. 241, the City of Atlanta was held entitled to maintain a suit for treble damages because it had purchased water pipe for a water works system and paid a price in excess of its reasonable worth, as a result of an illegal combination. And, of course, the excess amounts thus expended simply increased the operating expenses of the city, which in turn had to be met by municipal taxes.

In the recent case of State of Georgia v. Evans, 62 S. Ct. 972, the Supreme Court held that the State of Georgia was a person within the meaning of that term, as used in the Sherman Antitrust Act (15 U.S.C.A. 7), and was thus a proper entity to bring a suit for treble damages on account of purchases which it had made.

Obviously, in the case of the City of Atlanta and of the State of Georgia, the losses involved were borne by the taxpayers. It is not apparent how the City or the State could have a loss which would not be borne by them.

The loss which thus would be placed on the taxpayers, however, would be analogous to the loss which would be suffered by the stockholders of an ordinary business corporation which had been required to pay an excessive price (which had not been passed on to customers) for goods because of a violation of the antitrust laws. Such a loss is borne by the corporation and through the corporation by its stockholders in that "their equities" in the corporation are lessened or dividends are reduced or eliminated. It is obvious there could be no successful suit for treble damages by an ordinary business corporation if these considerations were held to mean that such a corporation had not as an entity suffered a loss.

In the cooperative oil case discussed herein the loss suffered by the members of the association was suffered by them as customers. If the violation had reduced the net savings of the association which normally would have reduced the amount available for eserves, or for distribution as patronage dividends, then it would appear that a situation would be presented in which an association should be held eligible to maintain a suit for treble damages because of damages to its business or property.

Reserves Nondeductible in Computing Income Taxes

There follows a complete copy of an unpublished decision of the Board of Tax Appeals of great significance to nonexempt agricultural cooperative associations:

UNITED STATES BOARD OF TAX APPEALS

SAN JOAQUIN VALLEY POULTRY PRODUCERS ASSOCIATION, Petitioner v. COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 103408

M. D. SAPIRO, Esq., for the petitioner.

HARRY R. HORROW, Esq., for the respondent.

MEMORANDUM FINDINGS OF FACT AND OPINION

The respondent has determined a deficiency in petitioner's income tax for the calendar years 1936 and 1937 in the respective amounts of $2,961.01 and $2,047.48, which arise from his disallowance of certain deductions claimed for reserves by the petitioner which is a cooperative association engaged in marketing eggs for members and non-member poultry raisers and in the sale and distribution of supplies. Three issues are raised, the first confined to 1936, the others common to both years: (1) whether respondent erroneously disallowed $1,683.56 as a deduction for a reserve for overpayments on egg sales; (2) deductions of $5,722.72 and $5,358.46, claimed for the respective years as reserves for a zoning hazard; and (3) deductions of $2,215.29 and $2,601.90, for the respective years, as reserves for security of membership.

The facts are as follows:

FINDINGS OF FACT

The petitioner is a cooperative association organized under the laws of California, with its principal place of business in Porterville, Tulare County. It filed its income tax returns for the years 1936 and 1937 with the collector of internal revenue for the Northern District of California.

The members of the petitioner are poultry producers. Membership is acquired by the payment of a $10 fee, as provided in the by-laws, which, with the articles of incorporation, were put in evidence and are incorporated here by reference. Petitioner has at Porterville, California, a feed mill, warehouses, and an office for the marketing of poultry and eggs on behalf of its members. During the years 1936 and 1937 its eggs were

marketed in weekly pools, and payment was made to the members participating in the pools on the basis of the number of eggs marketed by petitioner for each member, the proceeds to members being determined by the quotations in the Los Angeles market, less estimated expenses. Petitioner marketed eggs for non-members during the years 1936 and 1937, but the non-members did not participate in the pools. Eggs obtained from non-members were considered as cash purchases. During the years 1936 and 1937 petitioner sold feed and other farm supplies to members and non-members. The prices at which such supplies were sold to members were based on direct cost to petitioner, plus overhead expenses, the prices fixed being slightly above such expenses so that there would be no danger of loss to petitioner.

The following several resolutions were adopted by petitioner's board of directors on December 21, 1936:

1. One resolution authorized the payment of patronage dividends to members and non-members alike, for the year 1936, in cash or its equivalent.

2. Another resolution authorized the creation of an account on the books of petitioner designated "Reserve Against Loss by Overpayment", and recited that the aggregate amount retained from proceeds of the sale of eggs marketed by petitioner for members during the year 1936 was $1,683.56, and that this amount was to be credited to a Reserve for Overpayments in order to avoid loss from market fluctuations, deterioration, carrying charges, or unexpected expenses in the marketing of eggs by the petitioner on behalf of its members.

3. Another resolution authorized the sum of $5,722.72 to be transferred on the books of petitioner to an account entitled "Reserve for Zoning Hazard."

4. Still another resolution authorized the transfer of $2,215.29 to an account on the books of petitioner entitled "Reserve for Security of Membership", this amount being 10 percent of petitioner's net earnings as shown by its books for the year 1936.

5. Finally, a resolution provided for the declaration of a patronage dividend in the amount of $14,214.93, consisting of $11,725.75 to members and $2,489.18 to non-members, to be paid in cash or its equivalent. This, as the resolution stated, was a dividend of 2 percent on all purchases in addition to authorized reserves to members, and a larger proportion to non-members, "equalling in percentage the amount carried to reserves for accounts of members."

The following resolutions were adopted by the board of directors of petitioner at a meeting held on December 31, 1937:

1. One resolution recited that it was the intention of petitioner that its members should be credited on the books with their pro rata share of any amounts retained by the association which did not represent valuation reserves or other costs and expenses of petitioner, and that such credits should be paid to its members and patrons whenever its board of directors should determine that the petitioner had available funds therefor not needed for its use. The resolution authorized the accountants of petitioner to determine the amounts allocable as credits to the members, and to record such credits on the books of petitioner, and recited that the petitioner recognized the obligation to repay such credits in the manner stated above.

2. A second resolution authorized the transfer of $9,657.81 on the books of petitioner to an account designated "Reserve for Zoning Hazard."

3. Another resolution authorized the transfer of $2,601.90 on the books of petitioner to the account, "Reserve for Security of Membership," this amount being 10 percent of the net earnings of petitioner, as disclosed by its books for the year 1937.

4. Finally, a resolution declared a patronage dividend in the amount of $18,058.65, consisting of a dividend to members in the amount of $17,924.32 and a dividend to non-members in the amount of $134.33, to be paid in cash or its equivalent before closing its books for the year 1937. This dividend was, like that in the previous year, declared on a percentage basis to members and a larger percentage to non-members.

The account designated "Reserve for Zoning Hazard" was set up to provide against a change in the zoning ordinance of the City of Porterville. The plant of petitioner was in a residential region. Since there was no zoning ordinance authorizing petitioner to operate its plant, and the adjoining land owners asserted that its noise, dust, and dirt created a nuisance, and threatened to abate it; petitioner felt that a possible change in the zoning restrictions might require its removal, with consequent expense, and so set up a reserve to meet this contingency.

The "Reserve for Security of Membership" is provided for in the by-laws of petitioner, Article VIII, section 8, which provides as follows:

There shall be reserved out of the earnings of the business of the Association each year, ten (10) per cent of the net earnings for a Reserve Fund for security of the Membership Fund; such amount shall be computed annually, deducted after all other deductions for interest, overhead and operating expenses have been made and before "Members' Purchase Credits" have been prorated.

Any moneys in this Reserve Fund or in any other Fund may be invested in property belonging to the Association, in outside securities, or used as a working capital in the operation of the business, or used in the payment and retirement of the Feed Finance Fund Certificates and/or Advance Fund Certificates of the Association, or in payment of small balances standing to the credit of members in the "Members' Purchase Credits" record and in the "Members' Egg Pool Credits" record, all as provided for elsewhere in these By-Laws and all at the discretion of the Directors.

The amounts declared as patronage dividends, which were authorized by the resolutions summarized above were paid without any additional authorization of the board of directors. The resolutions declaring these dividends authorized them to be paid in cash or in interest-bearing certificates.

Article VIII, section 1, of the petitioner's by-laws provides as follows:

This association is organized as a non-profit co-operative organization doing business with its members and with non-members as provided in the Articles of Incorporation of this Association.

The "Net Proceeds" shall be such funds as are derived from overcharges on sales and as are left after all expenses shall have been paid, or provided for, all at the discretion of the Directors.

The "Net Proceeds" resulting from the operation of the business, if any, shall belong to the members and shall be known as "Members' Purchase Credits" and shall be prorated to them in proportion to the amount of business each member has transacted with the Association during the period of time in which said "Members' Purchase Credits" have accumulated.

The Directors, after providing for all necessary overhead and all duly authorized reserves, are authorized to prorate and refund all of the rest of the "Members'

Purchase Credits" to the members in proportion to each member's purchases from the Association during the time such "Members' Purchase Credits" shall have accumulated, all in the manner particularly set forth as follows:

Twenty-five (25) per cent thereof to be prorated and paid to the member in cash annually as soon as practical after the close of business at the end of each fiscal year and after the Auditor shall have completed the annual audit and shall have released his report to the Directors; seventy-five (75) per cent thereof to be applied to the creation and maintenance of a "Feed Finance Fund" all as provided for elsewhere in these By-laws.

The "Reserve for Security of Membership", which was authorized and provided for in the by-laws, was always credited before any patronage dividend was declared, for the purpose of protecting the petitioner against any loss in its working capital. No amounts credited to this reserve, pursuant to petitioner's resolutions summarized above, could be paid to any member or non-member without authorization of the board of directors of petitioner.

The purpose of the resolution authorizing credits to the "Reserve Against Loss by Overpayments", was to protect the petitioner against any payments of excessive amounts to members marketing their eggs in pools. The returns from the marketing of eggs was uncertain. When the petitioner paid its members for eggs still unmarketed and at prices then quoted on the market, it ran the risk that it would not realize as much when the eggs were sold by it. Uncertainty in estimating expenses was also involved. This reserve was intended to protect the petitioner against both these risks. No amounts credited to this reserve could be paid out without authorization of the board of directors of the petitioner. When any of the amounts were transferred to the reserves described above, the books showed the credits to such reserves but there was no physical segregation of cash or funds representing the amounts of these reserves. All of the moneys of petitioner were kept in one fund.

The policy of the board of directors was to authorize payment to members whenever the financial condition of petitioner was such that the amounts credited to the various reserve accounts could be paid to members without any detriment to petitioner. It was understood at all times that all the moneys represented by the reserves, which were, in turn, credited to the various accounts of the members, could be used by the petitioner for any of the purposes authorized in its by-laws. But if these amounts were to be used by petitioner for payment to members in cash or interest-bearing certificates, the payment had to be authorized by the board of directors of petitioner. They

could not be withdrawn by the member to whom it was credited. Sample ledger sheets taken from the books of petitioner, and put in evidence show the credits made to the accounts of the various members of petitioner, and a statement of membership equity for each member, a sample of which was put in evidence, was sent to each member at the end of each year.

Patronage dividends, when declared, were credited to the accounts of the members. The patronage dividends which were paid in cash or in certificates were kept on a separate ledger sheet. The ledger sheet in evidence contains credits for reserves for contingent expenses, such as reserves for legal and auditing expense. The statement of membership equity is an aliquot portion of the net worth of petitioner according to its books, allocated to the individual members on the basis of patronage.

OPINION

KERN: Petitioner is a cooperative poultry association which acts for both members and non-members. Petitioner claims the deduction of three reserves set up for (1) a zoning hazard, (2) the overpayment of egg sale proceeds, and (3) for security of petitioner's membership. The first is claimed for 1936 only, the others for 1937 as well. Respondent has disallowed all three. There is apparently no claim that the amounts credited to these reserves constitute expenses, and there is no evidence that the reserves were used to meet the contingency contemplated when they were set up. Of the several reserves, that for zoning hazard would seem to be the only one which might involve a risk indeterminable in its duration and in its cost until realized. The reserves for egg sale overpayments and for certainty of membership, on the other hand, might readily have been distributed in patronage dividend payments at the end of petitioner's fiscal year, when all accounts were settled. No evidence was put in on the reasonableness of the zoning hazard reserve, the only testimony being to the effect that removal of petitioner's buildings from the residential region where they were would cost a good deal. Since the reasonableness of this reserve has not been established, we must fall back on what appears to be, in any event, petitioner's principal reliance.

Petitioner insists in its brief that a proportionate part of all three of these reserves was allocated to each poulterer-member, was so credited on its books and so treated in the so-called "patronage" dividends distributed. The argument is, then, in effect, that the petitioner was a cooperative association under California law and the reserves constituting returns on proceeds of sales made by petitioner for its members did not belong to the petitioner and were not a part of

its taxable income. It is conceded by respondent that the petitioner was a cooperative association carrying on business on a non-profit basis, and that all petitioner's earnings and assets were ultimately distributable to its members, but he contends that except to the extent that such income or assets were subject to a member's sole command during the taxable year, they must be treated as belonging to petitioner, a corporate entity distinct during its existence from its constituent members. Fruit Growers' Supply Co., 21 B.T.A. 315; affirmed 56 Fed. (2d) 90 (C.C.A. 9); Farmers' Union Coop. Co. v. Commissioner, 90 Fed. (2d) 488 (C.C.A. 8); Coop. Oil Assn. v. Commissioner, 115 Fed. (2d) 666 (C.C.A. 9).

In the Fruit Growers' case at p. 93, this point was discussed:

> * * * A somewhat similar contention was considered by the Supreme Court in dealing with a mutual life insurance company. Penn Mutual Life Ins. Co. v. Lederer, 252 U.S. 523. It was held that, in computing the gross income of the insurance company, payments made by members could not be reduced by amounts which had not been actually repaid to them or credited to them within the taxable year. Until "patronage dividends" are declared they have not accrued as obligations from the corporation to its members. We agree in this regard with the conclusions of the Board of Tax Appeals which we quote as follows: "The petitioner now asks that we increase the patronage-dividend deduction on account of an amount which has not been returned to the members and when no dividend declaration has been made with respect thereto. We find nothing in the petitioner's by-laws which would cause these patronage dividends to accrue as such without corporate action setting them apart as a liability of the petitioner to its members." * * *

And in the Farmers' Union case, it was said, at p. 491:

> * * * While those who might be entitled to patronage dividends have, in a sense, an interest in the money, it is a character of interest not greater, if as great, as that of a stockholder in an ordinary corporation. Such interest never ripens into an individual ownership or right of ownership until and if a patronage dividend be declared. * * *

The zoning hazard reserve we have already discussed. Obviously it could not be used by the petitioner in the emergency of a compulsory removal under new zoning restrictions if it was subject to be depleted at any time by the petitioner's patrons. The over-payment reserve was to prevent loss to the petitioner through indeterminable expenses incurred in marketing eggs and

through the fluctuation in market prices between the day of the petitioner's purchase of eggs from its patrons and the day when it could resell them to the public. The membership security reserve was to avoid impairment in petitioner's working capital by a too sudden reduction in membership. It is true that the petitioner credited to its patrons on its books an aliquot part of each of these reserves, but in each case further action by its board of directors was necessary before any portion of these reserves could be made available to the members. On the other hand, patronage dividends in cash or certificates could be distributed on the authority of the resolution declaring them, without more. They were at once thereby subjected to the patron's "unfettered command" (to use the now classical phrase of Holmes, J., in Corliss v. Bowers, 281 U.S. 376.)

This essential difference serves to distinguish such cases as our recent Midland Cooperative Wholesale, 44 B.T.A. 824. We pointed out in that case that the Treasury Department, in the absence of any statutory provision allowing any deduction of patronage dividends, had shown "great liberality" in allowing them at all and that the justification for the allowance lay in the fact "that the so-called dividends are, in reality, rebates." (at p. 830). After discussing the Association's corporate structure we allowed the amounts credited to reserves and in proportion to each participating member's share on the ground that "the amounts so credited, in our opinion, could have been withdrawn by the members at any time. In at least two instances they were, in effect, withdrawn." (at p. 834).

Even a statutory deduction is a matter of legislative grace and not of right, New Colonial Ice Co. v. Helvering, 292 U.S. 435; and a deduction which is a matter of administrative grace necessarily rests upon even a narrower foundation. When a just and intelligible administrative line has been drawn between those reserves of a cooperative association which must be held rebates in order to satisfy substantial justice and those over which the patron-member has no control, and when that line has been upheld by this Board and the courts, we know of no way in which greater liberality can be properly accorded. See Cooperative Oil Assn. v. Commissioner, supra, at p. 668, and we, therefore, conclude that the deficiencies must be sustained.

Judgment will be entered for the Respondent.

Entered: June 18, 1942

The Board of Tax Appeals apparently decided the case on the ground that the reserves were not subject to the "unfettered command" of

the patrons. It was held that further action on the part of the board of directors of the association was required before any patron would be entitled to receive "his part" of the reserves.

In considering the foregoing opinion it should be kept in mind that it involved a nonexempt association. In fact, it is not apparent how the opinion has any special significance for an exempt association.

The Board distinguished the instant case from the case of Midland Cooperative Wholesale v. Commissioner of Internal Revenue, 44 B.T.A. 824 by pointing out that in the Midland case the amounts involved which were held in that case to be deductible in computing its income taxes "could have been withdrawn by the members at any time," while in the San Joaquin case the Board found that the reserves were not payable on demand as in the Midland case, but that further action by the board of directors was necessary before payments could be made.

Implicit in the holding in the San Joaquin case is the fact that the amounts in question were regarded as income within the meaning of the Federal income tax statutes. Because only income is subject to the payment of income taxes. (Edwards v. Cuba Railroad, 268 U.S. 628, 45 S. Ct. 614, 69 L. Ed. 1124). Again, the amounts which were held to be nondeductible in computing income taxes were not looked upon as expenses because an expense does not represent income but outgo. Likewise, these amounts for similar reasons could not have been looked upon as debts.

If the amounts involved had represented sums subscribed by the members of the association for capital therefor, it is clear that such amounts could have been excluded in computing the income taxes due by the association as amounts subscribed by members for capital purposes does not represent income. (Garden Homes Co. v. Commissioner of Internal Revenue, 64 F. 2d 593).

Scope of Authority of Agents of Cooperatives

In the California case of Christian et al v. Rice Growers Association of California, 123 P. 2d 534, it appeared that the plaintiffs had for some time been engaged in furnishing bags, sacks and twine to certain producers who were engaged in the growing of rice. They became apprehensive about the status of these accounts and talked to a representative of the rice association concerning them. It was admitted that the representative requested the plaintiffs to continue to furnish sacks to these producers. At that time the representative of the association, presented one of the plaintiffs with what he described as an order which was later signed by one of the producers. Thereupon the plaintiffs delivered merchandise to them. Several months later the plaintiffs wrote to the cooperative requesting payment of the account and were informed that the cooperative did not consider itself responsible for the obligation. It was apparently the contention of the plaintiffs that the representative of the association had entered into an agreement with them on its behalf under which the association agreed to pay for merchandise delivered to the producers. On the refusal of the association to make payment, suit was instituted against it. On the trial the only person which the plaintiffs called as a witness to establish that the representative with whom they had dealt had authority to enter into a contract obligating the association to pay for the merchandise involved was that representative. He testified unequivocally that he had no such authority and that he had not been authorized to buy sacks or to see to it that producers were supplied with them. He also testified that he did not inform one of the plaintiffs that the rice association would pay for the sacks, regardless of the outcome of the crop.

The trial court rendered a judgment in favor of the association and the plaintiffs appealed. In affirming the judgment the court said in part:

> We think that there was sufficient evidence to sustain the finding under the theory that Hyde was not the general agent of respondent, and clothed with the actual authority to bind it. Neither do we hold that the record, as a matter of law, shows that the agent had ostensible authority to bind respondents. It is provided in section 2317 of the Civil Code that "ostensible agency is such as a principal, intentionally or by want of ordinary care, causes or allows a third person to believe the agent to possess." Whether or not Hyde was the agent of respondent was a question of fact for the trial court. Willey v. Clements, 146 Cal. 91, 79 P. 850. The law is well settled that ostensible authority must be established through the acts or declarations of the PRINCIPAL and NOT through the acts or declarations of the AGENT. In Hansen v. Farmers' Auto. Inter-Ins. Exch., 139 Cal. App. 388, at page 393, 34 P. 2d 188, at page 190, the court states: "* * * It is well settled that apparent or ostensible authority of an

agent can arise by implication only from the words, act or conduct of the principal and not from anything said or done by the agent."

* * * * * * * * * *

The record in the present case shows that Hyde at no time did any buying of supplies for the account of the association, in fact, Hyde did not handle any of the finances of the association. There is no evidence that the association or any of its officers had any notice or knowledge of any claim that Hyde had attempted to bind the association to pay for the sacks and twine furnished by the appellants to Kalfsbeek and Tolson, and there is no evidence of any acts or declarations of the association or any of its officers which in any way could have led the appellants to believe that Hyde had any authority to bind the association by the purported purchase of sacks and twine for the use of a rice grower.

In reference to the issue of ostensible authority, the trial court properly held that: "* * * there is no evidence that Rice Growers Association knew Mr. Hyde acted in excess of authority, and the first proof of notice of Christian Bros.' claim against the Rice Growers Association, to the Rice Growers Association, was the letter written by Mr. Christian on February 7, 1938, three months after delivery of the bags and twine."

The rule is fundamental that neither the president, nor any other agent of a cooperative or of any other type of corporation, has any inherent authority simply by virtue of his office or employment, to enter into business transactions on its behalf, and unless authority to do so has been expressly or impliedly conferred upon officers or other employees, it is not possessed by them. (Sterling v. Trust Co. of Norfolk, 149 Va. 869, 141 S.E. 856). In this connection it was said in Aerial League of America v. Aircraft Fireproofing Corporation, 97 N.J.L. 530, 117 A. 705:

A corporation is bound by the act of an officer or agent only to the extent that the power to do the act has been conferred upon such officer or agent expressly by the charter, bylaws, or corporate action of its stockholders or board of directors, or can be implied from the powers expressly conferred, or which are incidental thereto, or where the act is within the apparent powers which the corporation has caused those with whom its officers or agents have dealt to believe it has conferred upon them.

As indicated, a cooperative or other corporation will be bound by the acts of an agent, if the agent is acting within the apparent scope of his authority, even though the agent has not been expressly authorized to enter into transactions of the character in question. An agent who has entered into transactions of a given type on behalf of a corporation, which have been recognized and carried out by the corporation, will usually be held to have authority to enter into similar transactions. The following quotation from the case of Wood Company v. McCutcheon, 271 Pa. 465, 7 A. 2d 564, bears on this matter:

> "A person who knows that the officer or agent of the corporation habitually transacts certain kinds of business for such corporation under circumstances which necessarily show knowledge on the part of those charged with the conduct of the corporate business assumes, as he has the right to assume, that such agent or officer is acting within the scope of his authority": Curtis Land & Loan Co. v. Interior Land Co., 137 Wis. 341, 118 N. W. 853, 857, 129 Am. St. Rep. 1068, 1076. Such a corporation is ordinarily liable for the acts of its officers if the board of directors knew or should have known that he was acting as if he had such authority: Weissburg v. People's State Bank, 284 Pa. 260, 131 A. 181; Culver v. Pocono Spring Water Ice Co., 206 Pa. 481, 56 A. 29; Dougherty v. Hunter, 54 Pa. 380. Apparent authority is such authority as the corporation knowingly permits the officer or agent to assume or which it holds him out as possessing.

In the case of David Stott Flour Mills, Inc. v. Saginaw County Farm Bureau, 237 Mich. 657, 213 N. W. 147, it was held that that farm bureau was not liable for flour which had been ordered in its name by a county agent who had not been authorized by its board of directors to order the flour, and who apparently had not been held out by the farm bureau as having authority so to do.

If a cooperative is to avoid liability or responsibility under a contract entered into by an agent, who acted in its behalf without authority, care must be exercised to avoid doing any act or thing which in any way recognizes the validity of the contract, because an unauthorized contract if within the scope of the association's powers, may be ratified by it before repudiation by the opposite party and on such ratification it is as binding as though previously authorized. (Stone v. Walker, 201 Ala. 130, 77 So. 554).

Who Are Members

In the case of Producers Livestock Marketing Association of Salt Lake City v. Commissioner of Internal Revenue, 45 B.T.A. ____, the Association contended that it was eligible for exemption from the payment of Federal income taxes. Apparently the Association met all conditions for such exemption except that the Bureau of Internal Revenue was of the opinion that it did more business with nonmembers than it did with members. The Association urged that all of its patrons were members even though they were not stockholders. In disposing of the case the Board of Tax Appeals said in part:

> Petitioner's claim is based upon the view that all of the producers whose products are marketed by it are expected to share in profits and therefore are its members, and for this view it argues upon legislative and administrative history. The pleadings and the testimony show that more business in value and amount is done for nonstockholders than for stockholders; but petitioner says that, since the statute uses the word members and this has a different meaning from stockholders, this evidence is not as controlling as it appears to be. It says that it has always contemplated that, if ever it was in a position to declare and pay a patronage dividend, the distribution would be to everyone, proportionately to the business done, without discrimination between stockholders and nonstockholders. This, it says, is what the regulations and the legislation have been leading up to as the ground for exemption. Such a liberal application of the statute would be at variance with the condition so clearly expressed. For, if all those for whom business is done are to be regarded as IPSO FACTO members, then there could be no business for nonmembers and the statutory condition is completely overridden.
>
> According to the articles of incorporation and the bylaws, no one can be a member until he becomes a shareholder. No one can vote unless he is a common shareholder, and he must have signed all agreements and fulfilled the requirements of membership. No one can participate in the management unless he is a common shareholder. While the officers testified that there is an intention that any distribution shall be proportionate and that records are kept as data for the apportionment, there is some doubt whether there is authority for this in the articles or bylaws.

The administrative interpretation is found in Regulations 86 and Regulations 94, article 101 (12). It contains this:

> An association will not be denied exemption because it markets the products of nonmembers, provided the value of the products marketed for nonmembers does not

exceed the value of the products marketed for members. Anyone who shares in the profits of a farmers' cooperative marketing association, and is entitled to participate in the management of the association, must be regarded as a member of such association within the meaning of section 101 (12).

Thus the statutory word member is recognized as qualified not only by the sharing of profits but also by participation in management.

Petitioner is not supported by Mim. 3886, C. B. X-2, p. 164 (7/9/31). The paragraph which it cites must be read with its introductory clause, as follows:

> However, where a cooperative marketing association has otherwise complied with the provisions of the statute respecting exemption, but defers the payment of patronage dividends to nonmembers, exemption will not be denied - - -
>
> * * * * * * * * * * *
>
> 2. Where the by-laws provide for the payment of patronage dividends to members but are silent as to the payment of patronage dividends to nonmembers, and a specific credit to the individual account of each nonmember is set up on the books of the association.

Thus the claimant for exemption must have complied with the provisions of the statute. This means that its marketing may not be greater for nonmembers than for members; and "members" means persons who share in profits and participate in management. This is made clear later in the ruling, as follows:

> However, under the Revenue Acts of 1926 and 1928 farmers' cooperative marketing associations may market the products of nonmembers only in "an amount the value of which does not exceed the value of the products marketed for members * * *."
>
> Membership in a cooperative association is, generally speaking, acquired in the same manner as membership in any other stock corporation -- through the ownership of one or more shares of stock. However, as heretofore stated, the statutes of a number of States provide that farmers' cooperative associations must be organized without capital stock. Therefore, as the exemption statute is silent as to the qualifications of members in farmers' cooperative marketing associations, it follows that anyone who shares in

> the profits of such an association, and is entitled to participate in the management of the association, must be regarded as a member within the meaning of that statute.

It must, therefore, be concluded that in the taxable years in question the petitioner marketed the products of nonmembers in an amount the value of which exceeded the value of the products marketed for members, and that it was not entitled to exemption.